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February 23, 2007

Mr. Lawrence Smith
EITF Chair
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: EITF Issue No. 07-B, “Accounting for Convertible Instruments that Require or Permit Partial Cash Settlement upon Conversion”

Dear Mr. Smith:

The International Swaps and Derivatives Association (“ISDA”) would like to offer its views with regard to the EITF Issue No. 07-B, “Accounting for Convertible Instruments that Require or Permit Partial Cash Settlement upon Conversion” (“Issue 07-B”), which was recently added to the EITF’s agenda. ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world’s major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments.

In summary, ISDA believes that the proposed alternative (View B) to the current accounting for convertible instruments with terms that require or permit partial cash settlement represents a broad change to a well codified framework of existing literature, including FASB Statement No. 133 and APB 14, and that accounting for this type of convertible debt is not an area in which there exists diversity of practice in interpretation, application, or otherwise. Given this view, ISDA does not believe that Issue 07-B represents a matter that should be or even can be resolved by the EITF given its complexity and pervasiveness in the capital markets. Additionally, isolating and establishing special rules related solely to this category of convertible instruments would require wholesale changes to the framework under which these instruments are accounted for under generally accepted accounting principles (“GAAP”). Another reason that we

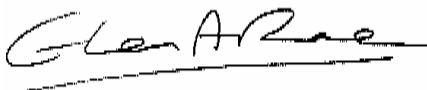
do not believe that the EITF is the best forum for resolving this matter is the amount of effort expended by the FASB on it under the liabilities and equity project. These views are largely consistent with a majority of the views expressed by the Board members at the January 3, 2007 FASB meeting who recommended not issuing guidance on convertible debt, but rather to address this subject in a more comprehensive manner under Phase 2 of the liabilities and equity project. Lastly, as expressed in Appendix I, ISDA believes that certain conclusions regarding View B of Issue 07-B are not well thought through and are not necessarily reflective of the economics (including for income tax purposes and under bankruptcy laws) of convertible instruments whose terms require or permit partial cash settlement upon conversion.

We ask that you share our views with the Board members, the EITF and the FASB staff. We hope you find ISDA's comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned or Hee Lee, ISDA's outside accounting advisor, at 212-773-8605.

Sincerely,



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Supplement to EITF Issue No. 07-B, “Accounting for Convertible Instruments That Require or Permit Partial Cash Settlement upon Conversion”

Proponents of View A do not agree with the EITF addressing this issue or View B of Issue 07-B from the Agenda Committee Report for several reasons:

1. This issue should be addressed within the FASB project regarding financial instruments with characteristics of both liabilities and equity and not by the EITF
2. View B represents a significant amendment to existing GAAP
 - a. View B represents a significant amendment to existing GAAP, in particular Statement 133, when analyzing hybrid instruments for the following reasons:
 - i. It supersedes current methodology in GAAP to analyze one particular type of hybrid instrument despite the fact that such particular hybrid does not differ in substantive economic effects from similar hybrid instruments not addressed in this issue
 - ii. The bifurcation methodology is not consistent with DIG Issue No. B6
 - iii. The bifurcation methodology does not accurately portray the claims in bankruptcy
 - b. View B would also amend APB 14, by focusing on the settlement of the convertible debt as the key determinant under APB 14 and not the true inseparability of the instrument and its outcomes
 - i. The economic substance of the conversion option in Instrument C does not create a “debt plus warrant” outcome as suggested by View B
3. Bifurcation concerns

1. This Issue Should be Addressed by the FASB, not the EITF, in its Project Regarding Financial Instruments with Characteristics of Both Liabilities and Equity

Proponents of View A note that the FASB is currently analyzing the appropriate model for liabilities and equity classification and the benefits thereof and no decision has yet been finalized. The FASB is in the process of analyzing this particular issue, and the accounting framework for convertible securities in general, within its long term project and is finding significant practical issues and complexities and therefore has preliminarily concluded that issuing individual accounting guidance for these financial instruments requires additional study and due process. Proponents of View A note that the proposed bifurcation methodology is similar to the separation principle in the “ownership-settlement approach” of the FASB’s liabilities and equity project.¹ At the January 3, 2007 Board meeting the FASB considered, and rejected, an alternative to issue an Exposure Draft of the ownership-settlement approach and also rejected a proposal to undertake a short-term project to address convertible debt accounting because it believes further analysis is needed in order to develop a comprehensive approach for analyzing all

¹ See “Principle 7—Initial Measurement: Separated Components” of FASB’s “Summary of Principles for the Ownership-Settlement Approach (revised November 1, 2006)”

instruments with characteristics of liabilities and equity.² The FASB instead committed to an aggressive timeline for the modified joint liabilities and equity project. Proponents of View A are not supportive of the EITF establishing GAAP, which the FASB specifically considered and did not agree with immediately implementing, that could potentially be superseded by the FASB's model in the future. Therefore, they believe this issue should be addressed by the FASB in the liabilities and equity project and do not support the EITF potentially providing piecemeal guidance for these instruments.

Additionally, proponents of View A do not believe this issue is within the scope of the EITF's mission. The mission of the EITF is to assist the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature.³ Proponents of View A note that View B is not based on existing authoritative literature. Rather it is based on an approach the FASB is merely considering in the liabilities and equity project covering all convertible debt. While View B has similarities to guidance under international GAAP⁴ ("IFRS"), the IFRS framework is a comprehensive model that applies to all convertible securities, not just those which require or permit partial cash settlement upon conversion. Proponents of View A note that the EITF is designed to promulgate guidance that reduces diversity in practice and to do so on a timely basis³ and fail to see why the accounting for these instruments represents an emerging issue (see Table #2). Instrument C type convertible bonds have existed for years and were addressed by the EITF in 1990 when discussing EITF Issue 90-19, in 2002 when EITF 90-19 was amended, and again in 2003 and 2004 when EITF 03-7 and EITF 04-8 were issued. Additionally, there is no diversity in practice in the application of the existing literature to these instruments. Therefore, proponents of View A do not believe additional guidance is warranted as the market (issuers and investors) have relied on the EITF's prior guidance regarding these specific instruments and have uniformly applied existing standards. Proponents of View A believe that standard setters should be focusing on creating a comprehensive accounting model for all instruments with characteristics of liabilities and equity, not creating a new one-off interpretation.

Further, if the EITF chooses View B and makes a decision that would require retrospective application, then proponents of View A would fail to understand how requiring restatement of financial statements when entities had been correctly applying existing GAAP improves financial reporting. As discussed above, the EITF has recently addressed issues relating to these types of convertible instruments and issuers have been relying on and correctly applying those conclusions since the respective points in time. Furthermore, there is no diversity in practice regarding the accounting for these types of instruments; therefore restatement would not improve comparability. Therefore, proponents of View A do not see the need for retrospective application of View B, which would cause a significant amount of restatements when companies were correctly applying existing GAAP.

² See "Minutes of the January 3, 2007 Board Meeting: Liabilities and Equity—Short-term Improvements Based on Certain L&E Decisions"

³ See "Operating Procedures" for the Emerging Issues Task Force – www.fasb.org/eitf/eitf_operating_procedures.pdf

⁴ Refer to International Accounting Standard 32, *Financial Instruments: Presentation*

2a. Significant Amendment to Existing GAAP, in particular, Statement 133

View B would require bifurcation of the equity component from Instrument C convertible debt. However, there currently exists a framework for analyzing hybrid instruments for bifurcation under Statement 133. According to that framework an entity must analyze embedded derivatives under paragraph 12 to determine if they require bifurcation, particularly if they are clearly and closely related to the host contract. Paragraph 61(k) notes that for convertible debt the equity conversion option is not considered clearly and closely related to the debt host contract and therefore must be bifurcated. However, paragraph 11(a) of Statement 133 notes that reporting entities (issuers of convertible debt) should not consider certain contracts to be derivatives, specifically “contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position.” To determine if the contract is indexed to its own stock an entity analyzes the contract under the guidance of EITF Issue No. 01-06, *The Meaning of “Indexed to a Company’s Own Stock.”* To determine if the contract is classified in stockholders’ equity in its statement of financial position an entity must analyze the contract under the guidance of EITF Issue No. 00-19, *Accounting for Derivative Financial Statements Indexed to, and Potentially Settled in, a Company’s Own Stock* (EITF 00-19).

Additionally, proponents of View A note that the bifurcation methodology used in View B is inconsistent with the bifurcation guidance in DIG Issue No. B6, “Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative.” Issue B6 notes that Statement 133 requires bifurcated embedded derivatives to be separated from the host contract at fair value. Therefore Issue B6 requires that the embedded derivative be measured at fair value and that the remaining amount of the hybrid contract be allocated to the host contract. However, under View B the opposite is true, the fair value of the debt host would first be determined with the remaining value assigned to the bifurcated derivative.

Further, proponents of View A note that the bifurcation methodology prescribed by View B does not accurately represent the Issuer’s liability claims in bankruptcy. Under the bifurcation methodology of View B the convertible would be accounted for by allocating the proceeds to the fair value of a similar debt instrument first, with the remaining balance to the equity option. However, the claims in bankruptcy against the convertible debt would be for the full amount of the par value of the debt plus accrued interest, but the amount shown in the balance sheet would significantly understate that amount.

Consider the following example:

An Instrument C type convertible is issued at par for \$1,000. Assume the fair value of the conversion option at issuance is \$250 and that the fair value of a similarly issued debt without the conversion feature would have a fair value of \$800. The table below illustrates the various bifurcation methodologies compared with the claims that would be received in bankruptcy if the company declared bankruptcy immediately after issuance.

Table #1

Non Bifurcation – Doesn’t Fail ¶11(a) of 133	
Debt proceeds	\$1,000 <i>(Debt proceeds equal claims in bankruptcy)</i>
Equity component	\$0
Claims in Bankruptcy*	\$1,000
Bifurcation under Issue B6 – Fails ¶11(a) of 133	
Debt proceeds	\$750
MTM Liability	\$250
Claims in Bankruptcy*	\$1,000 <i>(Debt proceeds plus MTM liability equal claims in bankruptcy)</i>
Bifurcation under View B	
Debt proceeds	\$800
Equity component	\$200
Claims in Bankruptcy	\$1,000
True Debt Plus Warrant Accounting	
Debt proceeds	\$762 <i>(800/1,050 x 1000)</i>
Equity component	\$238 <i>(250/1,050 x 1000)</i>
Claims in Bankruptcy	\$800

*Whether or not the conversion option is bifurcated from the debt, the current bifurcation framework under Statement 133 results in the full liability accurately portraying the claims in bankruptcy, whereas the bifurcation framework of View B does not.

To require Instrument C type convertibles to be bifurcated under the methodology in View B and by an EITF Issue would significantly amend the current accounting framework for analyzing hybrid instruments, in particular those with embedded equity derivatives. Proponents of View A believe that such a significant amendment would require an amendment to GAAP, in particular Statement 133, by the FASB and not the EITF. Additionally, Proponents of View A are concerned that if View B is affirmed that it will set a precedent for analyzing other embedded equity derivatives besides those in Instrument C type convertibles, which could lead to inconsistent application of bifurcation of equity derivatives in practice, thereby creating diversity in practice when none currently exists.

2b. View B Would Also Amend APB 14 by Focusing on the Settlement of the Convertible Debt and not the Inseparability

The EITF Agenda Committee Report dated January 29, 2007 notes that:

View B proponents observe that the APB's conclusion on the accounting for convertible debt was based on the inseparability of the debt and the conversion option such that the holder cannot exercise the option to convert into equity shares unless the holder forgoes the right to repayment of the debt component. They further observe that that rationale is not applicable to convertible instruments with the characteristics of Instrument C because the holder is entitled to both

repayment of the debt instrument and net-share settlement of the conversion option.

However, proponents of View A disagree with View B's rationale for viewing Instrument C as separable because View B does not portray the complete concept of "inseparability of the conversion option," and, as mentioned above, represents a significant amendment to existing GAAP.

Proponents of View B argue that Instrument C is not "inseparable" because the Instrument C outcomes allow both the repayment of the debt and net share settlement of the conversion option. View B proponents even note that under paragraph 7 of APB 14 "the most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option." View B asserts the outcomes are not mutually exclusive and View B suggests that an Instrument C holder is entitled to both repayment of the debt instrument and net share settlement of the conversion option.

However, proponents of View A believe that Instrument C is within the scope of APB 14 and that View B overstates its case because inseparability is actually a 2-step definition under APB 14 paragraph 7. The first half of paragraph 7 notes that the alternative choices of [debt or conversion option] ... "cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other." The second part of the definition emphasizes the "two choices are mutually exclusive; they both cannot be consummated. Thus the security will either be converted into common stock or redeemed for cash. The holder cannot exercise the option to convert unless he foregoes the right to redemption and vice versa."

Proponents of View A note that the non-separability of the debt and the conversion option in Instrument C are maintained because:

- the conversion option cannot be separated and traded (the first component of non-separability),
- the exercise of the conversion option does forgo the benefits of redemption (because the holder of the security loses title to the future interest payments of the debt, if any, and also gives up its debt claim in bankruptcy to the full par amount plus accrued interest and instead has a full equity claim in bankruptcy), and
- the cash delivered upon conversion under most Instrument C securities is equal to the lower of conversion value or \$1000 (where conversion value is Conversion Ratio x Stock Price). Thus a holder who converts is not "entitled" to a guaranteed minimum of \$1000 in all circumstances.

Because of these attributes, proponents of View A argue that Instrument C does meet the APB 14 definition of having "inseparable" debt and conversion option attributes from both a literal English definition (i.e., cannot be separated) and from the fact that a holder who converts irrevocably chooses an outcome that is not equivalent to a redemption from a bankruptcy claim, a right to receive future interest, or from a guaranteed right to receive the par amount back.

Proponents of View A acknowledge that in reaching their conclusions, the authors of APB 14 may not have considered convertible debt that settles in both cash and stock. However, proponents of View A believe those considerations were addressed in other accounting literature such as EITF 00-19, Statement 133 and FASB Statement No. 150, *Financial Instruments with Characteristics of Both Liabilities and Equity* (Statement 150). Additionally, the EITF has already analyzed instruments with these features and made conclusions under EITF 90-19 and EITF 03-7. Therefore, because an accounting model currently exists to analyze convertible debt with settlement that can occur in cash or shares, proponents of View A do not believe that additional guidance is necessary and that any such additionally guidance would represent a significant amendment to existing GAAP.

Additionally, the economic substance of the conversion option in Instrument C does not create a “debt plus warrant” outcome. APB 14 paragraph 18, as highlighted by View B, emphasizes that the Board recognized it was not practical at the time of APB14 issuance to discuss all possible types of debt with conversion features and guided that “securities not explicitly discussed should be dealt with in accordance with the substance of the transaction.” Therefore, because Instrument C was not specifically discussed proponents of View B believe it should be evaluated by the substance of the transaction. However, proponents of View A note that the substance of Instrument C is not similar to debt plus warrants for the following reasons:

- it is not separable and the conversion option cannot be independently traded,
- upon conversion, the entire instrument is extinguished (in debt plus warrants, the warrant is exercised and the debt continues to exist),
- the creditor claim in bankruptcy is that of a convertible bond, not a discount debt instrument,
- given all of the above, Instrument C is valued like a convertible bond, not “debt plus warrants.”

Furthermore, the economic substance of a convertible instrument that requires or permits partial cash settlement upon conversion is, to a holder, identical to that of a convertible instrument which requires delivery of shares upon conversion. This economic substance supports the view of consistent accounting for both instruments under APB 14, that is, the methodology required under View A.

3. Bifurcation Concerns

Proponents of View B state that the bifurcation computations of View B are already being performed for tax purposes as convertible instruments “typically” contain contingent interest provisions that entitle the issuer to deductions at the higher nonconvertible debt rate implying that issuers are already performing the computations required under View B.

Proponents of View A believe that Instrument C is a convertible bond and any decision regarding its classification and bifurcation should be consistent with existing accounting

literature such as EITF 00-19, Statement 133 and Statement 150. Second, proponents of View A note that the comment relating to contingent interest is not factually accurate. In 2006, only 20 of the 134 (15%) convertible bonds issued in the U.S. included contingent interest (thus such bonds are “atypical”). Additionally, the contingent payment debt instrument (CPDI) regulations allow deductions based on the \$1,000 issue price, not a discounted debt calculation as intimated by the View B discussion (i.e., there is no bifurcation required under the CPDI tax regulation). Further, it is not clear from an accounting perspective if the debt host instrument would have the same terms as the debt does for tax purposes, thus further complicating the bifurcation process. Third, it is misleading to portray the present value (debt) at a level significantly less than the creditor claim.

Table #2
Basic Factors to be Considered in Determining Whether an Issue Should be Reviewed by the EITF

Criteria⁵	Is Criteria Met?	Commentary
<i>Are there different interpretations of existing authoritative literature that have resulted or may result in diversity in financial reporting?</i>	No	There is no diversity in practice
<i>Is there a potential for diversity to be widespread and have significant effect on financial reporting?</i>	No	There is no diversity in practice
<i>Would financial reporting be improved through the elimination of the associated diverse reporting methods?</i>	No	There is no diversity in practice
<i>Is there conflicting guidance in existing authoritative literature?</i>	No	A clear framework already exists
<i>Is the issue a narrow implementation or application issue that can be efficiently resolved with the confines of existing authoritative literature?</i>	No	Implementation and application by issuers is already standard and uniform
<i>Can the issue be resolved independently of a separate issue outside the purview of the EITF?</i>	No	Already under review by FASB
<i>Is it probable that the EITF will be able to resolve the issue in less than one year?</i>	Uncertain	Given broad framework implications, likely will require substantial additional guidance to avoid diversity in application
<i>Would the practical experience of the EITF members contribute to the deliberation of the issue?</i>	Uncertain	The FASB has established a working group for the liabilities and equity project
<i>Is there pressing need to provide guidance related to a FASB project on a more timely basis than expected from the FASB's activities</i>	No	This issue is not "emerging" and does not pose a timing issue
<i>Is there an opportunity to converge U.S. practice with international practices through this issue?</i>	Somewhat	On a limited basis, this would move in the direction of convergence.

⁵ See "Operating Procedures" for the Emerging Issues Task Force - www.fasb.org/eitf/eitf_operating_procedures.pdf